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CENTRAL INTELLIGENCE AGENCY
DIRECTORATE OF INTELLIGENCE

5 January 1982

CANADA: CANADIAN ECONOMY SLIPS

After three quarters of strong growth, the Canadian economy slowed late last summer; consumer and business expectations have now dropped to an all time low, and there is little likelihood of a recovery until mid 1982. The slowdown was caused primarily by weakening demand--resulting from persistent inflation, record high interest rates, and a sudden jump in unemployment--and prolonged labor disputes in several key industries.

The deteriorating trend in the economy crosses all major components of final demand. Especially hard hit are industries manufacturing wood and wood products, pulp and paper, and automobiles. Despite an extensive rebate program, a decline in automobile sales forced producers to cut production by 50 percent over the third quarter and triggered extensive layoffs throughout the industry. Low demand caused industrial production to drop sharply in the third quarter, with manufacturing accounting for over 50 percent of the decline. Strikes, moreover, disrupted several sectors:

- The steel industry was crippled by a strike that idled nearly 60 percent of the workers for over three months.
- Mining, the forest industry, and the Post Office all experienced work stoppages of over a month.
- Several public service contracts are due for renegotiation, ensuring that labor problems will continue well into 1982.

In one of the few bright spots, the federal-provincial dispute over energy pricing has finally been settled, clearing the way for increased investment and production in the petroleum industry.

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This memorandum, requested by US Trade Representative Will Brock, was prepared by [redacted] the Western Europe Division, Office of European Analysis. Questions and comments may be addressed to the chief, Western Europe Division,

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Ottawa has singled out inflation as the major disruptive force in the Canadian economy. Rapid energy price increases resulting from the National Energy Program have boosted housing and transportation costs, lifting inflation to 12.5 percent in 1981. Since energy prices will continue to rise, little relief is likely in 1982. Until recently, Prime Minister Trudeau has been too preoccupied with constitutional reform to take action against inflation. In November, however, his new budget outlined a plan to reduce the government deficit by limiting expenditures--only defense and foreign aid were allowed real spending increases--and increase revenues by tightening the tax system. The restrictive budget has been a lightning rod for discontent over Canada's skidding economy and high interest rates. Most of the specific criticism, however, has been directed at details of the proposed tax reforms rather than at actual spending levels or the lack of measures to stimulate the economy. Finance Minister MacEachen has responded with two tactical retreats, making extensive accommodations on specific tax measures and allowing several to be reviewed by a parliamentary committee. [REDACTED]

For the moment, the tug of war over the budget and tax reform has masked the Tory opposition's lack of a real alternative program. The New Democratic Party, however, is likely to call for increased economic stimulation. The party's position was recently bolstered by the semi-official Economic Council of Canada's call for further policy measures to accelerate real growth. A sharp increase in the unemployment rate from 7.0 percent to 8.2 percent in September has reinforced demands for a more stimulative government policy. Even though the Trudeau government has a solid parliamentary majority, it may be forced to draw up a new budget within the next few months if this criticism continues to escalate. [REDACTED]

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High US interest rates have forced the Bank of Canada to raise its own rates in order to preserve the value of the Canadian dollar. Despite these measures, as interest rates in both countries climbed above the 20 percent mark, the Canadian dollar sank to a 50-year low. The high interest rates weakened demand, most notably in the consumer durables and housing markets. Housing starts plummeted, reversing a nine-month period of strong growth. Business investment, which had been booming, has also recently fallen victim to the high rates. Although interest rate levels have declined in the last few months, easing pressure on the Canadian dollar, the full beneficial effects on the Canadian economy may be delayed for several months. [REDACTED]

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External trade has suffered not only from strikes in Canada, but from slack demand in the US and Europe. Falling exports, and high import demand have kept Canada's current account in deficit. Exports, a large component of Canadian GNP, have slowed since May; in particular, auto parts, steel, and lumber product exports all fell sharply. Import demand, which peaked in July, reduced the merchandise trade surplus substantially from the \$6.7 billion of 1980. Efforts to diversify trading partners have not met with success, and Canada's continuing heavy reliance on the US market means that the Canadian economy will continue to be buffeted by economic winds from south of the border. Meanwhile, Ottawa's restrictive trade and investment policies have caused a deterioration of relations with the US and other major trading partners this year. [REDACTED]

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Canadian government leaders have been distracted from economic difficulties by pressing political problems. Recent breakthroughs, however, may allow them to focus more on the economy. After over a year of effort, Trudeau pushed through a constitutional reform package in November that will add a bill of rights to the charter and--following approval by British Parliament, perhaps as early as March--end Britain's formal control over the Canadian constitution. Although Trudeau was disappointed at some of the compromises he had to make, the resulting deal achieves much of what he sought. [REDACTED]

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CANADA: GENERAL ECONOMIC DATA

Population (1980): 24.03 million GDP (Purchaser's Value)/Capita (1980): \$10,832

Total Output (Billion \$US 1978 Exch Rate)	1977	1978	1979	1980
GDP (Purchaser's Value Current Price)	187.3	206.7	235.0	260.3
GDP (Constant Prices % Change by Year)	2.7	3.6	2.7	0.1
Cost of Living Index (1975 = 100)	116	127	138	152

Real GNP growth probably reached 2.5 percent in 1981 after virtually no growth in 1980. A strong first half gave way to a seasonally adjusted 4.0 percent decline in GNP in the third quarter, with negative growth likely to continue through early 1982. Continuous labor problems in several industries, most notably steel and lumber, contributed to a decline in industrial production. Record high interest rates and the slowing of the US economy, which will limit exports, have combined to curtail growth.

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Consumer prices rose 12.5 percent in 1981 compared to 10.2 percent in 1980. Although food prices moderated, the rapid energy price increases called for in the new Energy Agreement boosted housing and transportation costs, keeping the inflation rate high. The 1982 budget emphasizes monetary and fiscal restraint in order to deal with inflation, despite the unexpected jump in the employment rate last fall from 7.0 percent to 8.2 percent.

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Canada's current account deficit was at 5.2 billion for the first three quarters of 1981. Vastly increased interest payments on foreign currency loans, the result of government-urged takeovers of foreign interests in the petroleum industry, will contribute to a large services account deficit. High first half import demand, due to high fixed capital spending and a build up of inventories, helped lower the merchandise trade surplus to \$3.9 billion, down from the record \$6.7 billion in 1980.

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TRADE AND PAYMENTS (Billions \$US, BOP Basis)	1977	1978	1979	1980
Exports of Goods and Services	49.3	55.1	65.8	77.2
Import of Goods and Services	53.8	59.5	70.6	79.9
Balance of Goods and Services	-4.5	-4.4	-4.9	-2.7
Current Account Balance	-4.1	-4.3	-4.2	-1.6
Longterm Capital	3.7	1.1	1.8	0.8
Total Reserves Minus Gold (yearend)	3.7	3.6	2.9	3.1

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DCI Briefing: US-Canadian Economic Relations

- I. One-tenth the size of the United States in population and economic activity, Canada accounts for more US trade and business investment than any other foreign country.
 - A. Canada takes 15 percent of total US trade--\$39.8 billion in exports and \$40.4 billion in imports in 1980--which is one-and-a-half times the US trade with Japan and half the size of trade with all of Western Europe.
 - B. The US is even more important for Canada, accounting for 67 percent of total Canadian trade; US companies account for 80 percent of total foreign direct investment in Canada (\$35.3 billion in Canadian property and assets).
 1. US firms control 67 percent of Canada's petroleum industry, 32 percent of pulp and paper, 36 percent of mining and smelting, and 39 percent of manufacturing as a whole.
 - C. With a domestic market about the size of California's, Canada is sensitive about living in the US economic shadow.
- II. Bilateral relations are complicated by the vision that Prime Minister Pierre Trudeau and his Liberal Party have of Canada's needs for the 1980s and 1990s.
 - A. Politically, Trudeau aims for stronger government control over Canada's 10 contentious provinces, which wield considerably more power than US states.
 1. Britain will probably relinquish its vestigial control over Canada's charter in March or April, selling the constitution in Quebec could take years.
 - B. Trudeau's Liberals want the central government to guide the economy in concert with industry and labor but with the government dictating the pace and direction.
 1. Their model is closer to the Japanese system which uses a consultative, tripartite approach to develop a competitive trade advantage, than to either free enterprise or socialism.

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2. The Liberals see this as the only way for Canada to compete in the future.
3. They blame the private sector and foreign--especially US--domination of key industries for the branch-plant, natural resource-dominated character of the Canadian economy.

III. Liberal policy has been hampered by economic setbacks in recent years.

- A. In 1980 real GNP stagnated. In 1981 real growth reached 2.5 percent, but was again flat in the last half of the year.
- B. Over 8 percent of the workforce is now unemployed, with little prospect of improvement in 1982.
- C. By the end of 1981, inflation had reached 12.5 percent with no relief in sight.
- D. Canada's current account deficit, \$1.9 billion in 1980, grew in 1981 as the trade surplus dropped from its record \$6.7 billion to around \$3.9 billion.

IV. Politically, Trudeau frequently appears torn between the urge to play leader of the Third World and the desire to hold his own with the industrial giants. Economically, however, he clearly wants Canada to jettison its Third World image.

- A. To position Canada for the 1980s and 1990s, Trudeau believes he must increase Canadian ownership and control of key industries. Energy resources and high technology industries--particularly electronics and aircraft construction where Canada already has expertise--are priorities.
- B. Trudeau recognizes that his plans place Canada more directly in competition with the US.

V. To gain control over foreign investment, the Trudeau government established the Foreign Investment Review Agency (FIRA). in 1974

- A. FIRA regulations establish preferences for firms with larger Canadian ownership and content, mandate export performance levels, limit domestic distribution of foreign firms, and encourage research and development expenditures in Canada.
 1. Although FIRA dealings with foreign firms are secret, they appear ad hoc and uneven.

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2. US firms complain that they never know what will be required to win FIRA approval and that
3. The US has initiated proceedings under GATT charging that FIRA regulations discriminate against US firms.

B. Ottawa has threatened further action, such as allowing FIRA to aid Canadian companies pursuing takeovers.

VI. Nationalization of foreign--mostly US--assets has thus far been limited to the energy sector.

A. The National Energy Program (NEP), announced in October 1980, aims to increase Canada's ownership of energy to 50 percent.

1. Direct Canadian ownership in the energy sector rose from 28 percent to 33 percent last year.

2. Firms with large Canadian ownership and control are given preference for exploration grants on federally owned land, and the state-owned oil company--Petro-Canada--receives an automatic 25-percent interest in all production on federally owned land.

- a. Foreign firms operating on federal land accuse Canada of changing rules in mid-game. US and Canadian officials are negotiating with the companies over compensation.

B. Trudeau would like to nationalize other sectors--especially mining and chemicals--but has been deterred by economic and financial restraints.

VII. Conflict over energy is not limited to the NEP.

A. Differences between Ottawa and the western energy-producing provinces were not completely settled by agreements reached in 1981.

B. Energy nationalizations have proceeded more rapidly than anticipated, draining capital, forcing increased foreign borrowing, and helping to push the Canadian dollar to a 50-year low last summer.

C. Ottawa is nervous about the money it has invested in the Alaska Pipeline.

1. Although Canadians interpreted remarks by President Reagan as a sign that the US will

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fulfill its part of the deal, they still fear the US will drop out because of lagging gas demand.

D. Canada's gas producers, caught between a worldwide glut and high prices dictated by Ottawa, insist on long-term contracts that require consumers to pay for contracted gas whether they take it or not.

1. US firms have been using only 70 percent of the amounts originally contracted.

VIII. Several other problems continue to trouble US-Canadian relations.

A. Canada periodically tries to renegotiate the 1965 bilateral Auto Pact.

1. The Pact, which calls for limited free trade in automotive products between the US and Canada, is designed to allow Canada's smaller industry to specialize in producing new models and parts.

2. The Canadian share of the North American market has not expanded as expected, partly because of the switch to smaller models.

B. Through the new Committee on Industrial Megaprojects and Regional Benefits, Ottawa seeks to encourage the use of Canadian supplies and services for large projects.

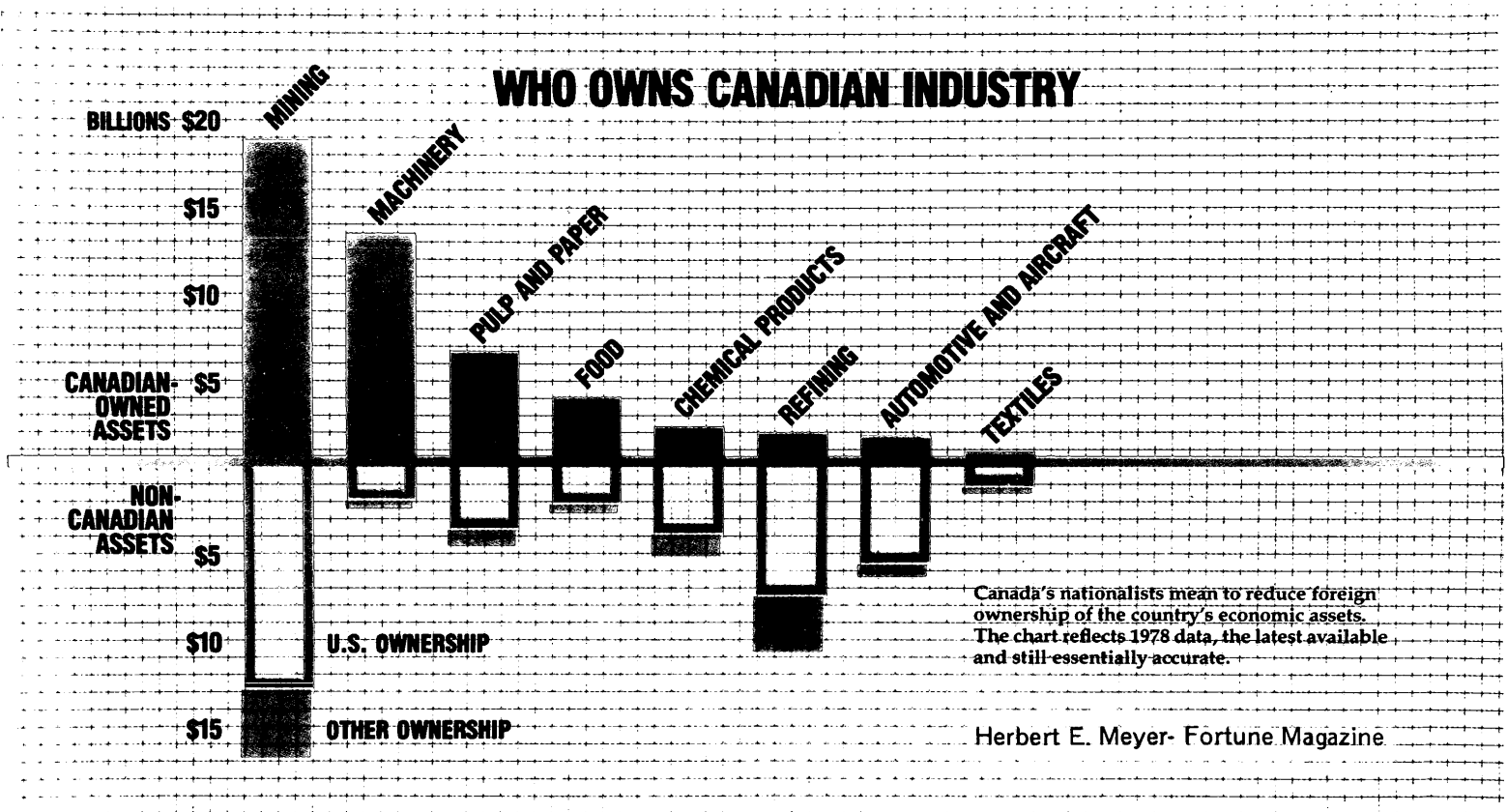
1. Because the Committee failed to define competition adequately, the US has threatened a GATT investigation of preferential treatment of domestic goods.

C. Canada has bridled at US attempts to force American subsidiaries in Canada to comply with US laws.

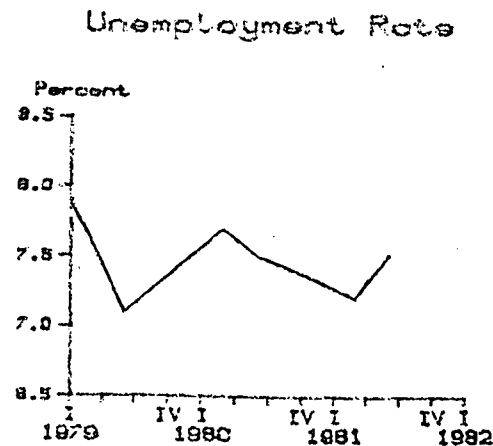
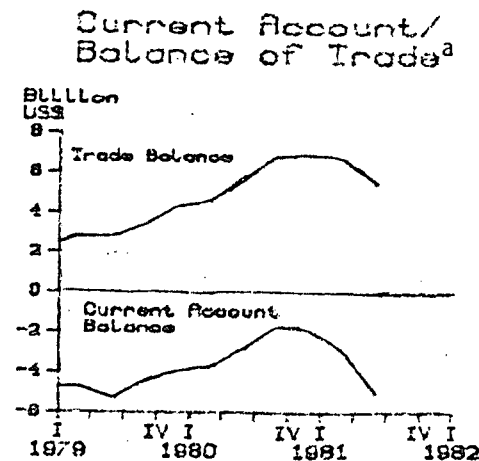
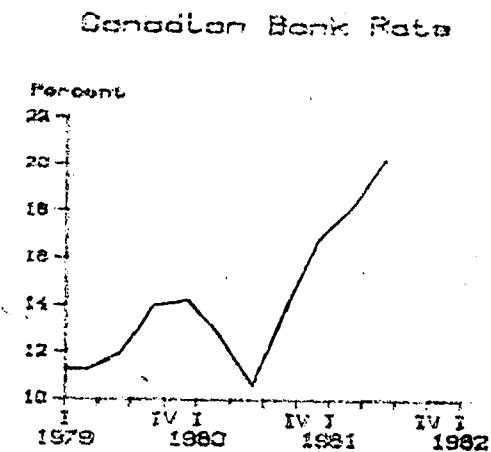
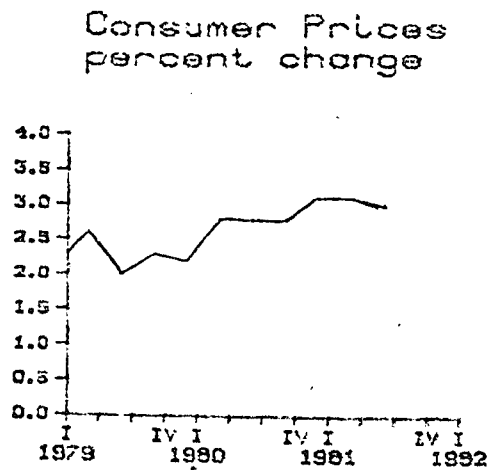
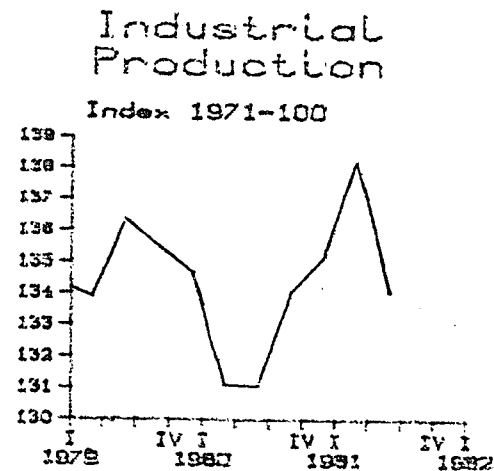
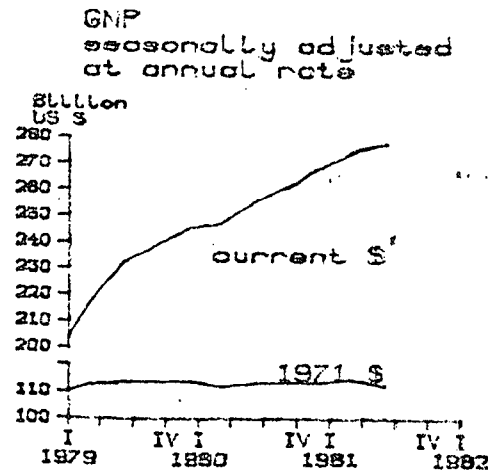
D. Ottawa wants the US to pay for "acid rain" damages to Canadian lakes and streams.

E. There are periodic quarrels over use of the Grand Banks fisheries.

F. Canadians are also upset that high US interest rates attract capital away from Canadian markets, depreciate the Canadian dollar, and worsen terms of trade.



Canada: Economic Indicators



a. Seasonally adjusted, at an annual rate.